Reading Your Financial Statements

"What gets measured gets done."
-Frances Schagen

Healthy Numbers = Healthy Business

The financial health of your business is your lifeblood. No matter how great your product or how passionate your marketing, if your financials aren't in order, you won't be in business long.

Yet, most independent retailers have only a basic understanding of the numbers that accountants and bankers use to determine your future.

There are certain numbers you need to know. There are certain ratios you need to measure. There is helpful information hidden inside those documents the accountant gives you each year.

When you understand the numbers, you can manage them and make them work for you. When you understand the numbers you know when to change course or stay the course. You know when there is a problem before the problem becomes unmanageable

The purpose of this book is to help you understand the basic financial numbers you should know and how to use that information to make smarter decisions regarding your business.

Here is a sample of one document you should know—the **Balance Sheet**. *(you may want to print this page for reference)*

Balance Sheet

ASSETS		
Current Assets		
Cash	40,600	21.4%
Inventories	115,300	60.7%
Other Current Assets	600	0.3%
Total Current Assets	156,500	
Fixed and Non-Current Assets		
Property and Equipment		
Leasehold Improvements	50,000	
Furniture & Fixtures	100,000	
	150,000	
Less accumulated depreciation	(116,600)	
	33,400	17.6%
Total Assets	**$ 189,900**	
LIABILITIES		
Current Liabilities		
Note payable to bank	0	0.0%
Accounts Payable	26,800	14.1%
Current maturities of long-term debt	1,600	0.8%
Accrued Liabilities:		
Compensation, payroll taxes	3,500	1.8%
Taxes, other than income	3,500	1.8%
Income Taxes Payable	3,500	1.8%
	10,500	
Total Current Liabilities	**38,900**	20.5%
Long-Term Debt, less current maturities	15,400	8.1%
	$ 54,300	
EQUITY		
Retained Earnings	105,600	
Owner Contribution (Withdrawal)	15,000	
Common Stock Value (100 shares)	15,000	
	$ 135,600	71.4%
TOTAL LIABILITIES & EQUITY	**$ 189,900**	

Reading Your Financial Statements

Understanding the Balance Sheet

Your Balance Sheet is broken down into three sections: **Assets, Liabilities** and **Equity.** Line by line, here is what each term means:

Assets

Current Assets: the stuff you can easily turn into cash

- **Cash** – the money you have in your checking account and cash drawers
- **Accounts Receivable** – the money that is owed you by customers such as a layaway balance or financing program
- **Inventories** – the total replacement value of all the inventory you have on hand

Other Assets: the other stuff you're holding that isn't as liquid but still has value such as:

- **Cash Surrender of Life Insurance** - this is an example of a non-liquid asset

Fixed and Non-Current Assets (Property and Equipment)

- **Leasehold Improvements** – the money you have sunk into the physical structure of your building
- **Furniture and Fixtures** – things like computers, cash registers, copier, fax machine, desks, shelves, display fixtures, etc.
- **Less Depreciation**—This is a measure of how those Improvements, furniture and fixtures have lost value over time.

Liabilities

Current Liabilities: the money you owe right now

- **Note Payable to Bank** (Short-term Loans) revolving loans that are used for things like inventory or operating costs (these are usually loans that need to be paid off at least once each year)
- **Accounts Payable** – money you owe to vendors and service providers
- **Current Maturities**—what you owe this year on a long-term debt
- **Accrued Expenses** (payroll, taxes) – money you owe at year end such as taxes and payroll that has not yet been paid

Long Term Debt – any other loans you might have such as a mortgage or capital improvement loan or money you have borrowed from your friends or family.

Equity

Equity shows you your earnings. The two numbers listed are simply what the business has earned over the years and what you have taken out of the business. The two terms are:

Retained Earnings: This is simply a sum of all of the Net Income (after taxes) from your **Profit & Loss** over the years. If your business shows a profit each year, this number will grow.

Owner Contribution (Withdrawals): If you put money into the business as an owner that would be here (or under long-term debt if there is scheduled payback or interest payments). If you do not pay yourself a salary, but instead take money out when you show a profit, that would be reflected here as a negative number (a Withdrawal)

*(Note: Mid-year Balance Sheets will have a line labeled Current Earnings or **Net Income.** At the end of your fiscal year that will become part of the **Retained Earnings**.)*

What is really cool about the **Balance Sheet** is how the numbers add up.

Assets = Liabilities + Equity

The Balance Sheet is an important tool for understanding how you manage your assets, how you manage your money. It is a snapshot in time of where things stand for your company.

Assets and Liabilities are changing with every purchase, sale, and bill paid. Often the bank will look at your Balance Sheet and calculate certain ratios that tell more of what is happening in your business.

Here are two ratios you can calculate easily enough that help show you how well you are managing your assets.

Current Ratio

The **Current Ratio** tells us how much you have in Current Assets compared to Current Liabilities. The math looks like this:

Current Assets ÷ Current Liabilities

In our sample, the equation shows:

$156,500 ÷ $54,300 = 2.88

Any number above 1.5 means you should have ample current assets to cover your current liabilities. Of course, this calculation includes your inventory and ***assumes*** you have the ability to sell that inventory. If your number is much lower then you need to figure out a way to decrease your Liabilities.

Cash to Current Liabilities Ratio

Another Ratio that is commonly calculated from your Balance Sheet is the **Cash to Current Liabilities Ratio**. This ratio is slightly different than the previous ratio because it only deals with the cash you have on hand. The equation looks like this:

Cash ÷ Current Liabilities

This number is expressed as a percentage. In our sample the math looks like this:

$40,600 ÷ $54,300 = 75%

According to some accountants, this ratio should be in the 10-20% range. If you are below 10% then you run the risk of not having enough money to withstand a short-term loss of business. But if you are a seasonal retailer, you will probably want a much higher percentage to make sure you have sufficient cash to be able

to grow your inventory quick for your season.

Taken together, these two ratios can tell you a lot. For instance, if your Current Ratio is fine but this last one is not, then you have too much inventory and not enough cash. You probably will need to sell off some inventory to give you capital for other expenses.

Knowing how to read your Balance Sheet will help you understand how well you are managing your inventory and your cash flow. It is an essential tool for your financial health.

(Note: the sample Balance Sheet was designed for simplicity's sake. Your Balance Sheet may have more detail. If you have lines in your Balance Sheet that you do not understand, ask your accountant.)

Profit and Loss (Statement of Income)

The next accounting report to understand is often called the **Profit & Loss** or **P/L**, but may also be called the **Statement of Income** or **Income Statement.** *(isn't accounting fun?)*

While the Balance Sheet is simply a snapshot of what you have in Assets and Liabilities right at that moment, the P/L is a record of what your business has done over a period of time.

Most companies will print a comparison **Profit & Loss** to show this year (or year-to-date) and last year.

Here is a sample **Profit & Loss** report.

Profit & Loss (Statement of Income)

REVENUE			
Net Sales		532,000	100.0%
Cost of Goods Sold		277,700	52.2%
	Gross Profit	**254,300**	**47.8%**
EXPENSES			
Payroll Expenses		99,500	18.7%
Occupancy Expenses		72,400	13.6%
Administrative Expenses		69,700	13.1%
	Total Expenses	**187,000**	**45.4%**
PROFIT			
Operating Profit		12,700	2.4%
Interest Expenses		2,700	0.5%
	Profit Before Taxes	**$ 10,000**	**1.9%**
Taxes		2,500	
	Net Income	**$7,500**	

Understanding the Profit & Loss

Here are the terms you need to know.

REVENUE—The Money You Made

Net Sales: All of your money received from sales. Pretty straightforward stuff that your Point-of-Sale software *(you do have a POS system don't you?)* can calculate for you.

If you don't have a POS, you should be tracking your daily sales in some fashion that would give you this number. *(And you should be budgeting to get a POS* *system—they pay for themselves in no time at all.)*

COST OF GOODS SOLD: Also called COGS, also called Cost of Sales. This number is calculated the following way:

Beginning Inventory (at cost)
+ Purchases
+ Freight-In
- Ending Inventory (at cost)
= Cost of Goods Sold

Beginning Inventory: The amount of inventory you have on hand at replacement cost at the beginning of the period being measured.
Purchases: Everything you paid out for the merchandise you sell.
Freight-in: Everything you paid to freight companies or your vendors to get the product to your door.
Ending Inventory: The amount of inventory at replacement cost at the end of the period being measured.

Cost of Goods Sold is inversely related to your profit margin. For instance, if your COGS is 52% (as shown in example) then your profit margin is 48%. If your COGS is 65%, your profit margin would be 35%. A typical independent retailer needs a COGS in the 50% to 55% range or lower to be profitable (and conversely a Profit Margin around 45-50%)

Freight-In: Some accountants consider the freight costs associated with bringing in merchandise to be an Expense. Some consider it part of the COGS. Either way is acceptable, but do note that how you calculate it will change your COGS. If you are trying to compare to industry averages, be sure you know how those averages are calculated—with or without freight.

GROSS PROFIT: Your Gross Profit is simply the money you have left over from buying and selling your goods that will be used to pay for the rest of your expenses.

EXPENSES—THE MONEY YOU SPENT

There are many ways for separating your expense accounts for tracking. The most common way is to use the three categories;

Operating, Selling and Administrative

Unfortunately, many businesses get bogged down about what expenses go into each category. If your accountant wants you to use this method and you are not sure how to categorize your expenses think about them this way:

Operating = keeping the building open
Selling = keeping the product flowing
Administrative = keeping the business going

Another method that is more intuitive for most retailers is the one described in our sample P&L.

Payroll, Occupancy and Other

PAYROLL EXPENSES: Includes all salaries, wages, bonuses and benefits, including group insurance and retirement plans. Payroll taxes are also included here.

Occupancy Expenses: These include the costs to keep the building open such as utilities, rent or mortgage, property taxes, repairs and maintenance.

Other Expenses: These include all the rest of the costs including advertising, liability insurance, depreciation, bank service charges and fees, store supplies, professional fees and licenses, travel expenses and any other miscellaneous expenses.

PROFIT

Operating Profit: This is simply your Gross Profit minus your Expenses. If your Expenses are greater than your Gross Profit, this will be a negative number (in parentheses) and reported as a Loss.

Interest Expense: Some accountants will list Interest Expense under Expenses. Some will subtract it from your Operating Profit to get your pre-tax bottom line. Either way is acceptable.

The Bottom Line

At the very bottom of the **P/L** is an important line, your **Net Income** (also called Net Profit).

Simply put, it is the money you made or lost last year. While it is not good to lose money, it is not *always* a bad thing. If you have high **Retained Earnings** *(from the Balance Sheet)*, then you can absorb a bad loss or two.

Most importantly, however, the P/L helps you measure how well you did compared to your expectations and helps you **budget** for the next year.

Checking your Profit & Loss monthly shows you if you are on track with your projections. If you don't know how to read your P/L and understand the story it tells you about your business then planning for the future becomes difficult.

No Excuses

At the end of the day, it is your job to know the financial health of your business.

When you understand your **Balance Sheet** and **Profit & Loss**, you'll know how to grow your business.

If ever in doubt, ask your accountant to help you understand your financial statements.

To learn about other important business numbers including tips & tricks to managing Cash Flow, download the free eBook **Inventory Management** *at* ***www.PhilsForum.com/Freebies.html***

Special thanks to Frances Schagen for her assistance with this document. Find Frances at www.BusinessOwnersSuccessClub.com.